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Foreign aid, institutional quality, and growth

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ABSTRACT

Using a panel of up to 116 countries from 1970 to 2010 we estimate the effects of foreign aid flows on a variety of measures of institutional quality. We find that aid flows are associated with the deterioration of both political and economic institutions. Regarding the latter, aid flows are associated with deterioration in a recipient's legal system and property rights, as well as its openness to international trade. Controlling for both political and economic institutions in growth regressions, the latter is robustly, positively associated with growth. After controlling for institutional quality, aid flows are not otherwise significantly related to growth.

1. Introduction

Institutional quality is an essential ingredient for economic growth. As Rodrick et al. (2004) famously proclaimed: *institutions rule*. And while foreign aid is aimed at promoting growth and prosperity in developing nations, some researchers have argued that its effectiveness is a function of institutional quality (e.g., Burnside and Dollar, 2000, 2004). Recent evidence suggesting that aid flows are detrimental to institutions is therefore doubly troubling (Svensson, 2000; Rajan and Subramanian, 2007; Heckelman and Knack, 2008; Djankov et al., 2008). Aid may harm the very institutions under which it can be effective; the same institutions that promote economic growth.

There are plausible reasons why aid flows might be detrimental to a recipient's institutional quality. For example, a government receiving aid is less reliant on the collection of tax revenues. It may therefore be less responsive and accountable to its citizens. Aid flows are also windfalls that are disbursed through specific channels. The rewards to controlling the channels (rent-seeking) may be high relative to the rewards from productive activities (Baumol, 1990). Like the flow of rents from a subterranean natural resource, aid may "curse" a country by exerting a corrupting influence on its institutions (Djankov et al., 2008).[1]

In this paper we investigate the links between foreign aid, institutional quality, and growth. Up until now there have been three fairly distinct literatures on the effects of (i) aid on growth, (ii) institutions on growth, and (iii) aid on institutions. One of our contributions is to explore (i), (ii), and (iii) together with a single panel composed of data from up to 116 countries and covering the years

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[1] Evidence of natural resource curses has been reported in several influential papers including Auty (1990) and Sachs and Warner (1999, 2001). A recent study by Crivelli and Gupta (2014) reported that natural resource revenues significantly crowd out governments' non-resource revenues (with the elasticity being about 0.3).

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1970 through 2010. Another of our contributions is to tie these separate literatures together, asking which (if any) dimensions of institutional quality are likely channels through which aid affects growth.

Specifically, we ask which dimensions of institutional quality (e.g., economic versus political freedoms) are significantly affected by aid flows. Those affected dimensions are potential channels through which aid affects growth. We then estimate growth regressions including all of the affected dimensions to determine and identify the ones that are likely to be indirect channels through which aid affects growth. In doing so, we control for the direct effect of aid on growth. This last step acknowledges that there are certainly other channels through which aid affects growth (e.g., through increasing the resources available for investments).

Our analysis includes a large number of institutional quality measures, including Polity IV scores, the Economic Freedom of the World (EFW) index from the Fraser Institute, the checks and balances measure from Keefer and Stasavage (2003), and both the political rights and civil liberties measures from Freedom House. Besides including a larger number of institutional variables than previous studies, we also break the EFW into its five constituent components, separating the effects of aid on, e.g., the legal environment and property rights versus the size of government. This gives us a finer picture of which economic institutions are affected by aid flows. Given this large number of measures of political and economic institutions, our study is unique in analyzing the effects of all of them using a uniform identification strategy.

We find that aid flows are associated with decreases in measures of both political and economic institutional quality. Relative to the sample variation in our institutional measures, the effect on economic institutions is larger. Controlling for all of the affected measures, only decreases in economic institutional quality are significantly associated with lower rates of economic growth. Discerning from the data which of the specific dimensions of economic institutional quality matter most is difficult. However, the evidence most strongly suggests that deteriorations in international trade freedoms are a channel through which aid affects growth.

This paper is organized as follows. A review of the relevant literature and an explanation of how our paper contributes are contained in Section 2. Section 3 contains a description of our data and econometric strategy. Our empirical results are presented and discussed in Section 4. Concluding comments constitute Section 5.

2. Existing literature and the present paper

There is a substantial literature addressing the effect of foreign aid on economic growth. The conclusions of individual researchers are varied. Our reading of the literature suggests that a consensus, though by no means a unanimity, exists: at best aid contributes positively to growth only in good policy environments; at worst it is detrimental to a recipient's development. Our reading of the literature, however, will undoubtedly be controversial. As Rajan (2005) concluded: “the debate about aid effectiveness is one where little is settled.”[2]

In the 1970s Peter Bauer (1972) was a relatively lone voice among economists in questioning the effectiveness of foreign aid. Inspired by Bauer's work, however, Boone (1996) provided a seminal econometric study reporting that aid is not associated with higher growth or investment in developing countries. This pessimistic view of aid was tempered by the later research of Burnside and Dollar (2000, 2004) who found that, while aid has little impact on growth on average, it does have a positive impact on growth in good policy environments. Subsequent studies by Collier and Dehn (2001a, 2001b), Collier and Dollar (2002, 2004), and Collier and Hoeffler (2004) reported similar results.

The Burnside and Dollar research proved remarkably influential in the development community but not uncontroversial. Easterly (2003) and Easterly et al. (2004) argued that the Burnside and Dollar results are sensitive to small changes in the time period and countries included. Rajan and Subramanian (2008) is another recent study that failed to find a positive effect of aid even in good policy environments. Worse yet, Barro and Lee (2005) actually found the effect of aid on growth to be negative. However, other researchers are more sanguine about the potential for aid to foster growth. Influential papers by Hansen and Tarp (2000, 2001) found that aid increases growth in recipient countries and that this positive effect is not conditional on a good policy environment.[3] Dalgaard et al. (2004) and Karras (2006) reported similar results.[4]

A large literature also addresses the effect of institutions on economic growth. Inspired by the seminal work of North and Thomas (1973) and North (1990), these studies relate differences in growth rates across countries to “the humanly devised constraints that shape human interaction” (North, 1990, p. 3). Such constraints include, but are not limited to, private property rights and regulatory structure (*economic freedoms*) and the structure of elections and systems of checks and balances in a government (*political freedoms*). While Rodrick et al.'s (2004) assertion that *institutions rule* is not uncontroversial, nearly all students of development recognize the critical role of institutional quality in growth outcomes.[5]

Several early cross-country studies found that strong private property rights are associated with higher income per capita levels (Knack and Keefer, 1995; Hall and Jones, 1999; Acemoglu et al., 2001, 2002). Barro (1996) analyzed a broader set of institutions,

[2] Doucouliagos and Paldam (2008, 2009, 2011) conducted meta-analyses of, respectively, 100 and 68 papers examining the effect of aid on growth. In both meta-analyses they conclude that the effect of aid on growth is not statistically significant. Bjørnskov (2013) is a recent and novel attempt to use factor analysis to break aid down into different types according to its intended purposes: (i) economic, (ii) social, (iii) reconstruction, and then (iv) a residual type. He reports that only (iii) has significantly positive effects on growth.

[3] Hansen and Tarp reported that the effect of aid in growth regressions disappears when human and physical capital investments are included as controls. However, they also found that aid positively affects investment. According to Hansen and Tarp, then, investment is the likely channel through which aid fosters economic growth.

[4] Bjerg et al. (2011) present evidence from 38 least developed countries (LDCs) that aid does not generally foster growth, but may be beneficial if the country is highly-indebted and uses the aid specifically to alleviate that debt burden.

[5] The chief alternative offered to the primacy of institutions in growth determination is geography. See Gallup et al. (1999) and Sachs (2003). Glaeser et al. (2004) have also argued that, while institutions are important, human capital is a more fundamental source of economic growth.